BOGSD-1414

Bank of America

Economic Outlook California 1984

Overview

December 1983

California's economic growth in 1984 will be greater than in any other year of the last decade. Building upon the recovery that began in 1983, growth in 1984 will spread to most sectors of the economy. The state's inflation-adjusted Gross State Product (GSP) will increase 7 percent, exceeding the gains registered during the 1976 to 1978 boom years. California's rate of growth will top that of the nation as a whole.

Despite this renewed strength, some constraints to further expansion persist. Interest rates will remain relatively high, limiting growth in the interest-sensitive sectors of the economy, particularly housing and durable goods manufacturing. Also, while some improvement in worldwide economic conditions is expected during 1984, the rate of improvement will be relatively slow. This will slow the state's export growth, particularly in the agricultural, aircraft, and electronics industries—all heavily dependent on expanding international markets.

Employment in most sectors of the economy will increase in 1984. Overall, 500,000 new jobs are expected. At the same time, the state's labor force will expand rapidly. As a result, unemployment will decline only moderately.

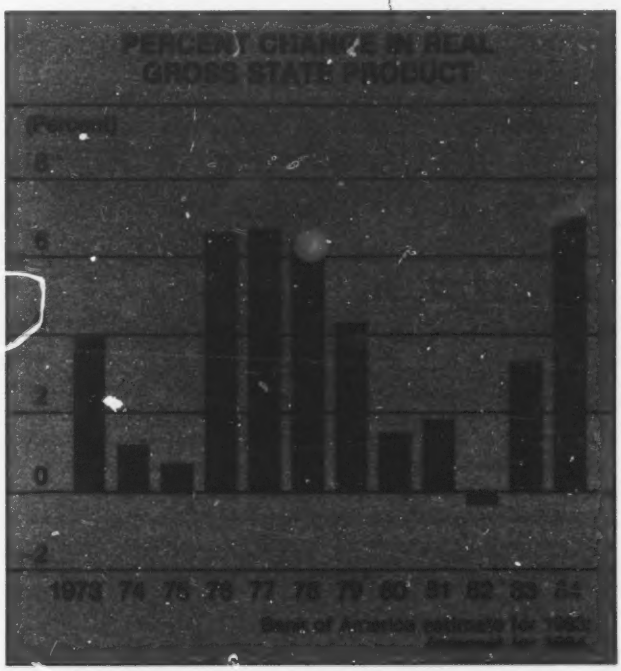
Inflation, as measured by the Consumer Price Index, will increase 5.3 percent in 1984. This is up considerably from 1983, but is far less than the 9.5 percent average for the 1978 to 1982 period. Increased employment, together with moderate wage increases and relatively low inflation, will result in an improved standard of living for Californians in 1984. Real personal income will rise by 4.8 percent.

New home construction is expected to continue to increase in 1984, but at a lower rate than in 1983. Housing construction will be up 15 percent during the year, while sales of existing houses should increase 10 percent. Since construction and home sales are highly dependent on the level of interest rates, any significant increase in rates will dampen prospects for growth in this important sector.

Defense spending will continue to play a major role in the California economy. An estimated 15 to 20 percent of state growth in 1984 will be attributable to the increase in defense-related production.

Net farm income is expected to reach $3 billion in 1984, up 11 percent from 1983. Agricultural production will increase sharply as farmers expand cultivated acreage following a year of severe cutbacks. In 1983, many farmers participated in the federal government's Payment-In-Kind (PIK) program to reduce production of grains and cotton. Increased farm production in 1984 will boost overall economic activity in agricultural regions of the state as farmers increase their purchases of fertilizers, pesticides, and other inputs.

With the prospect of general economic improvement in 1984, tourism in California should advance strongly. In addition, two special events—the Summer Olympics in Los Angeles and the Democratic National



Convention in San Francisco—are expected to result in significantly increased spending by visitors. Extensive media coverage of these major events is expected to boost tourism in the future as well.

Strong economic recovery will produce increased revenues for state government, forestalling the need for any increase in the state sales tax to achieve a balanced state budget during the 1983-84 fiscal year. However, continued austerity policies have virtually stopped employment growth in government—the only major employment sector expected to show no job gains in 1984.

Factors Shaping 1984 Growth

Developments contributing to the favorable 1984 outlook include: 1) increasingly large defense-related expenditures by the federal government, 2) continued rapid growth of the state's high technology industries, 3) increased housing activity, 4) expanded production from the state's manufacturing industries, 5) greater agricultural production, 6) boosted tourism stemming from generally improved economic conditions as well as the Summer Olympic Games in Los Angeles and the Democratic National Convention in San Francisco.

In many respects, the nature of California's industrial base positions it to outpace the nation during the current recovery. A large percentage of the nation's defense and civilian high technology industries are located within the state. California is geographically situated to participate in much of the rapidly expanding international trade business with the Pacific Rim countries. Favorable timing of the Olympics and the Democratic Convention will give the state considerable press coverage as improving economic conditions stimulate tourism.

During 1983, the California economy was in the early stages of recovery. Strength was concentrated in a few sectors of the economy; rapid growth in these sectors helped lead the rest of the economy out of recession. In particular, the construction, building materials, and trade sectors expanded as declining interest rates early in the year spurred consumers to buy houses, autos, and other durable goods. In 1984, the economic recovery will spread throughout the state's industries.

The recovery is, however, subject to a number of uncertainties; the most significant of which is the level of interest rates. Rising rates would threaten the national recovery and have an exaggerated impact in California, primarily because of high house prices. Any significant increase in rates would result in a sharp reduction of housing construction and sales. Another uncertainty involves the world economy. If conditions fail to improve as rapidly as expected, that too would detrimentally affect many state industries, especially agriculture, aircraft, and electronics.

1984 HIGHLIGHTS

- Economic growth in California will be the strongest in the last ten years.
- Half a million new jobs will be created in a wide spectrum of the state's industries.
- The unemployment rate will decline throughout the year, averaging 8.8 percent.
- Personal income will increase 7.4 percent per California household.
- Retail sales will continue to rebound with an 11.7 percent increase.
- Inflation will rise 5.3 percent, up from 1983, but well below 1979 to 1981 rates.
- New housing construction will reach its highest level in five years.
- Net farm income will rise to $3 billion in 1984, up 11 percent from 1983, as farmers return to full production.

SELECTED ECONOMIC INDICATORS FOR CALIFORNIA 1982-1984

	1982	1983	1984
	(Percent change)		
Real Gross State Product	-0.3	3.3	7.0
Total Employment	0.4	1.2	4.5
Labor Force	3.2	1.1	3.4
Personal Income	7.5	6.7	10.3
Retail Sales	0.7	12.5	11.7
Inflation	6.5	2.0	5.3
Housing Starts	-20.3	98.7	15.0
Net Farm Income	-6.3	20.0	11.0
	(Percent of labor force)		
Unemployment Rate	9.9	9.6	8.8

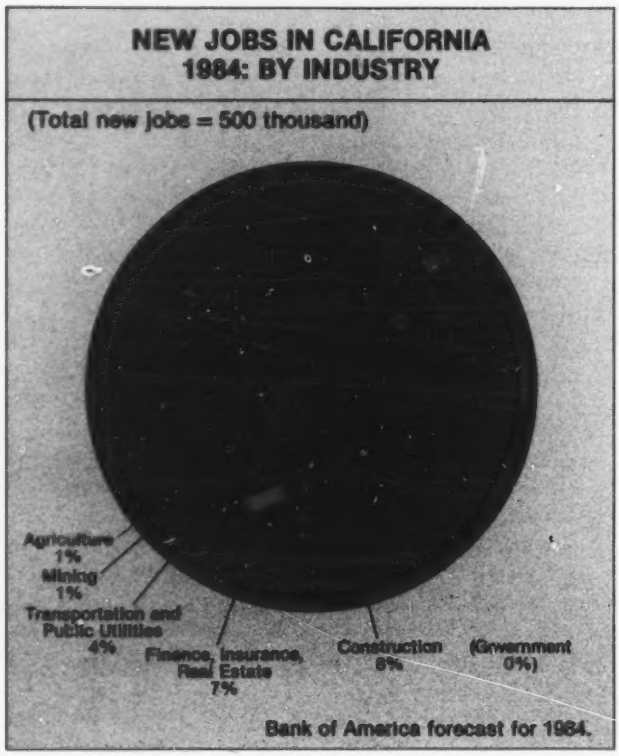
Basis of California estimates for 1982; forecasts for 1984.

Employment and Labor Force Expand

There will be 500,000 new jobs created in California in 1984—the largest employment gain since 1978, and a 4.5 percent increase from 1983. Employment will surpass its pre-recession peak. Job growth will

be larger and more widespread than in 1983. Gains will be evident in agriculture and many manufacturing industries. Only government will fail to register increased employment.

Responding to rising demand by businesses and consumers, the trade and services sectors will add employees very rapidly in 1984. Together, these sectors will create about 255,000 new jobs, slightly over half of the state's total new employment. Business services will be particularly strong. As computer use increases, so will the demand for computer software, as well as computer consulting and maintenance services.



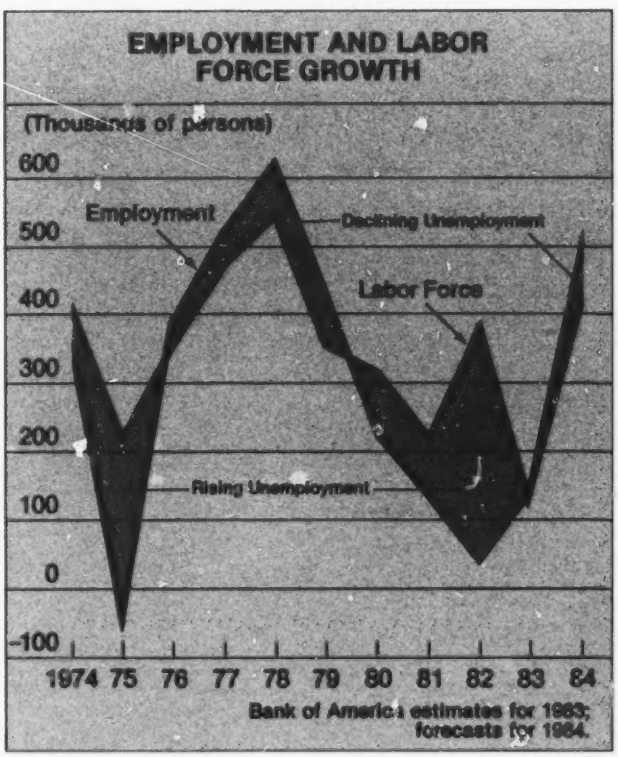
Manufacturing firms will add about 140,000 workers in 1984 as most major manufacturing industries report job gains. As the recovery gathers momentum, job gains will be spread throughout the manufacturing sector. Continued growth in residential housing construction will bolster job growth in the building materials industries. The defense and high technology industries will post further employment increases. About 30,000 new manufacturing jobs will be added by these industries during 1984. The primary and fabricated metal industries will increase payrolls sharply as businesses throughout the economy increase investment in plant and equipment. The food processing industry will register the first substantial employment gain in four years.

Continued growth in the housing sector will lead to job gains in the construction industry. Total employment in that industry will rise by 40,000 workers, bringing total construction employment for the year over the 425,000 level for the first time since 1981.

Gains in other sectors of the economy—transportation and public utilities, mining, agriculture, insurance, and real estate—will generate about 65,000 new jobs.

Because growing stringency in state and local public sector budgets has forced widespread austerity, government employment will not rise in 1984. However, rapid expansion of the economy during 1984 should relieve some of the recent budget difficulties experienced by the California state government.

As new hiring increases, the state's unemployment rate will recede significantly from the recession peak of 11.2 percent registered in February 1983. For 1984 as a whole, the rate will average 8.8 percent, a full percentage point down from 1983. The unemployment rate would drop much more were it not for a resumption of rapid labor force growth in the state. During the latter part of the 1980 to 1982 recession, labor force expansion virtually stopped in California despite continued high rates of migration into the state. People who would otherwise have been looking for work apparently were discouraged by the lack of available jobs. As conditions in the economy improve, more people will re-enter the labor force, slowing the decline of the unemployment rate.



Income, Sales, and Inflation

Higher employment levels coupled with improving business conditions will lead to a 10.3 percent increase in personal income during 1984. Because inflation is expected to remain moderate, the real income gain will be relatively large, about 5 percent. This compares to an average of slightly less than one percent over the past five years.

Expected real income gains in 1984 will contribute to continued increases in retail sales which began in mid-1983. Retail sales will reach $162 billion, an increase of 11.7 percent. Led by continuing improvement in sales of automobiles and household furnishings, durable goods sales will increase 13 percent. Sales of nondurable goods will rise more gradually, about 11 percent from their 1983 level.

Inflation in 1984 will increase about 5.3 percent. While this rate will be higher than inflation during 1983, it will still be far below the 9.5 percent inflation rate registered during the 1978 to 1982 period. The very low rate of 2.0 percent in 1983 resulted in large measure from falling energy prices, a slowdown in the rate of house price appreciation, and declining interest rates early in the year.

In 1984, higher food prices, modestly higher automobile prices, and rising rents will put upward pressure on consumer prices. Interest rates and energy costs will remain relatively stable, contributing little to inflation.

California's rate of inflation is expected to be close to the national rate. Because of a revision of the Consumer Price Index, house price increases will now play only a small part in the computation of the index. Due to increases in the housing component of the price index in the late 1970s and early 1980s, the overall rate of inflation in California exceeded the national rate by at least one-half percentage point in 6 out of 8 years since 1975.

Despite the fact that house price appreciation in California will continue to exceed appreciation nationally, the reduced importance of house prices in the index will lead to a decreased difference between California and U.S. inflation rates.

Real Estate

New Housing Construction

New housing construction is expected to increase 15 percent in 1984 while sales of existing houses are expected to rise 10 percent.

Continued recovery of the state's housing market depends almost entirely on the level of interest rates. As long as rates remain stable or decline, housing activity will continue to increase throughout the year.

Several conditions support the increase. First, there is a substantial pent-up demand for new houses in the state. New construction declined every year between 1978 and 1982. Not until 1983 did this trend finally reverse. Consequently, only a portion of the demand was satisfied in 1983, and the need for more new houses continues.

Second, late in 1983 builders returned to using interest rate subsidies to sell new houses. Use of these subsidies will continue into 1984, causing the effective interest rates paid by buyers to be below quoted rates. It appears that the threshold interest rate above which the demand for new housing declines is around 12 to 13 percent for fixed-rate loans. For adjustable rate mortgages (ARMs), the threshold is somewhat less. Many builders are offering to "buy-down" the interest rates 3 percentage points the first year, 2 percentage points the second year, and 1 percentage point the third year. This type of purchase arrangement is rapidly gaining in popularity.

The third reason new construction will continue to increase in 1984 is that builders are constructing a larger number of affordable houses. Construction of smaller attached and detached houses on smaller lots is occurring. These houses, which are priced below $100,000, sold more rapidly in 1983 than larger houses.

Finally, construction of rental apartments will increase in 1984. With vacancy rates at low levels, rents rising, and changes in tax laws allowing larger deductions for depreciation expenses, increasing numbers of investors are viewing apartments as a profitable investment.

The near 100 percent increase in housing starts recorded in 1983 was the largest in the post-World War II era in California. The sharp rise in 1983 will be followed by a smaller increase in 1984. However, while the rate of growth will not be nearly as high, the number of single-family housing starts will be far above levels achieved in the 1980-82 period and represents a strong return of the California housing market. California will again produce over 10 percent of the nation's houses.

Resales

Sales of existing houses will increase by 10 percent in 1984. Several factors support this conclusion. First, like builders, many sellers are again offering subsidized financing to buyers. The use of seller financing increased in the last half of 1983 and is expected to continue at substantial levels through 1984. Sellers will offer loans to buyers at below-market rates of interest in order to close deals. Hence, existing houses will continue to be competitive with new houses.

Second, ARMs will attract more buyers because they, too, are priced initially at rates of interest below fixed-rate loans. Consumer acceptance of

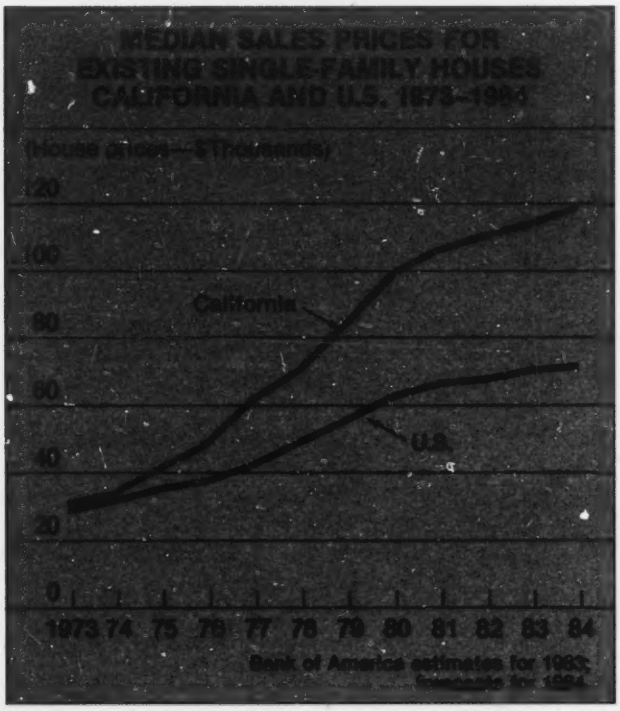
ARMs is growing, and in 1984 over 50 percent of all houses sold will involve the use of these mortgage instruments. Many lenders now offer capped ARMs that guarantee the interest rates will not increase above a certain level; caps of 3 to 5 percentage points over the life of the loan are common. Most lenders also offer ARMs with periodic caps that place a limit on the amount by which the rate may change in any given year. In addition, some lenders offering ARMs are converting to less volatile indexes on which to base changes in monthly mortgage payments. In short, ARMs are becoming less risky, more acceptable, and will be used by more people to finance houses in 1984.

While sales of existing houses will increase in 1984, constraints remain. High real rates of interest will continue to discourage demand. Also, the slow appreciation of nominal house prices, averaging 5 percent per year since 1980, has reduced the investment potential of home ownership, thereby lowering demand. Finally, home owners continue to have inflated expectations about what their houses are worth. Consequently, sellers will hold firm to inflated prices which will constrain the market.

Housing Prices

Prices of existing houses will increase about 5 percent in 1984, in line with the expected rate of inflation. Greater price appreciation is not likely because there is still a large inventory of existing houses on the market. Also, because many buyers currently spend between 35 and 50 percent of their gross income for house payments, they cannot afford to significantly bid house prices higher. A major uncertainty likely to affect house prices in 1984 is the extent to which concessions made in financing by sellers will be capitalized into house prices. In 1981 and 1982 the capitalization of seller financing pushed house prices 5 to 10 percent above what they would have been had only institutional financing existed. To the extent this occurs again, house prices will be somewhat higher than indicated.

Consumers will not only seek financing for new and existing houses in 1984, but will look for refinancing opportunities as well. In 1983 large numbers of homeowners refinanced loans which were made at high interest rates during the period 1979 to 1982. During that time over $27 billion in loans were made in California at interest rates over 14 percent. In fact, almost $7 billion of those loans were originated at rates over 16 percent. In 1984 home owners will continue to refinance their loans at more favorable rates.



Defense Industry

Defense spending continues to play a major role in the state's economic outlook. Approximately $55 billion will flow into California in 1984 as a result of the federal government's military spending. Because the growth rate of this spending is so high—8 to 9 percent in real terms—defense spending represents an even greater contribution to California economic growth. It is estimated that some 15 to 20 percent of the state's 1984 growth rate is attributable to the increase of defense-related production.

The portion of the defense budget spent on military hardware, such as missiles and ships, is particularly important to California's key industries. The U.S. government will spend more than $15 billion in California in 1984 for these items, which will directly impact the growth of the aerospace and communications industries, and indirectly affect industries such as electronics, instruments and supplies, and business services. California is the leading state in defense-related production of ordnance and accessories, communications equipment and instruments, aircraft and parts. The average annual growth rate of defense production in these industries is more than 10 percent, or almost three times the growth rate of non-defense production in these same industries.

The magnitude of the role of defense spending in the state's economy has always raised questions about the susceptibility of state economic growth to sudden reversals in defense expenditures. The military spends more money in California than in any other state. California also has the largest number of jobs dependent on defense outlays. Consequently, any large reductions in defense spending have

considerable adverse impacts. Further, the military can be a volatile and capricious buyer, pressuring for lower prices and generally impeding long-range planning by defense contractors. However, since defense budgets through 1985 have been approved already, steady increases in defense spending are virtually certain over this period.

Electronics Industry

Despite intense competition from other states for high technology companies, California-based electronics firms are expected to generate some 30 percent of the output of the U.S. electronics industry in 1984. The largest and fastest growing segment in California's economy is the computer industry, with 15 percent real growth and more than $16 billion in sales forecast for 1984. Yet, as has become apparent in recent months, the outlook is not problem-free. Rapid industry growth does not ensure against individual company failure. Throughout 1984, California, as the center of the nation's personal computer industry, will also be the center of employment layoffs, company mergers, and the general "shake-out" among personal computer manufacturers and suppliers. However, with strong growth expected for other segments of the California electronics industry (most notably the more mature semiconductor parts and components industry), workers laid off in the computer industry should find employment elsewhere within the electronics industry.

The recovery of the semiconductor industry from declining sales in 1982 and 1983 will continue in 1984. All key semiconductor users—the auto industry, aerospace, the communications industry, and the computer industry—will be growing at rates requiring a substantial increase in semiconductor shipments. However, intense competition both within the U.S. industry and from companies abroad creates great pressure to reduce manufacturing costs. This in turn encourages California firms to locate manufacturing operations in lower-cost areas outside California.

The high cost of living in California is being closely evaluated by the electronics industry against the educational and cultural advantages of the state. High housing costs and the increased congestion of areas such as Silicon Valley continue to impede the expansion of the industry in the state. Expansion is critically dependent upon the supply of senior and research engineers. If California firms cannot attract and keep these engineers at a reasonable cost, then research and manufacturing facilities may be moved to other states or offshore. However, no massive shifts are imminent; there are few other areas offering California's combination of advantages.

Agriculture

Gross farm income is expected to reach $16 billion in 1984—a 7.4 percent rise from 1983—as field crop farmers return to full production. Net farm income should also improve, reaching $3 billion in 1984, an 11 percent increase from the previous year. Overall production costs should increase substantially in 1984 as growers expand cultivated acreage and utilize additional quantities of inputs. Some increases in farmland values will help to improve the financial strength of many California farmers.

California farms will expand production in 1984 following severe cutbacks in acreage under cultivation during 1983. The federal government's Payment-In-Kind (PIK) program took 1.5 million acres of field crops, mainly cotton and rice, out of production. Although the program benefited field crop producers through monetary incentives, rural economies suffered a severe setback from the reduced activity. In 1984, farmers will plant extensively as crop prices improve and the PIK program is significantly reduced. The expansion of acreage under cultivation will boost regional economic activity in agricultural areas such as the San Joaquin, Sacramento, and Salinas Valleys, as farmers increase purchases of fertilizers and pesticides.

Vegetable producers will be beneficiaries of the expected increase in grain and cotton plantings in 1984. Because vegetables compete for acreage with these crops, fewer acres of vegetables will be planted, thereby lowering production and leading to an improvement in prices.

Overall increases in production will boost net farm income in 1984 when compared to 1983. However, the high levels of net farm income realized in 1979 and 1980 will not be matched. The key reason net incomes will not increase more dramatically is that California agriculture has become increasingly dependent on exports for growth, and exports of agricultural commodities are in a period of decline. In 1982, farm exports from the state dropped 21 percent, and they declined further in 1983. Reduced exports can be attributed to the strength of the dollar, weak worldwide economic growth, and protectionist agricultural policies in Europe and Japan. A slight increase in exports is likely for 1984.

The outlook for livestock, the largest sector of the state's agricultural economy, is uncertain for 1984. Feed prices have jumped as supplies were reduced due to the PIK program and the drought in the Midwest. As a result, livestock producers' margins have narrowed, forcing producers to consider cutbacks in production. In addition, net incomes of dairy producers are being reduced, as the federal government is making assessments on milk production to help offset costs of operating the dairy price support program.

Agricultural land values declined nearly 4 percent in 1983 from 1982 levels. Reduced production, low commodity prices, and a slowdown of inflation all contributed to the decline. Farm properties are for sale, but little buyer interest has been exhibited and transactions are few. However, with prices of many farm products increasing in 1984 as a result of improving economic conditions, farmland values will increase by as much as 5 percent.

Tourism

California leads the nation in tourism. From 1977 through 1982, travel outlays grew about 14 percent annually and are estimated to reach $26 billion in 1983. These expenditures—approximately 50 percent for private and public transportation, 37 percent for food and lodging, and 13 percent for entertainment and incidentals—are estimated to support over 500,000 jobs.

However, growth in California travel expenditures has slowed during the recession, reflecting high unemployment and reductions in business and personal travel. Foreign travel to the United States fell an estimated 4 percent in 1982 because of the weak global economy and continued strength of the U.S. dollar. Foreign travel to California was hurt as well by major devaluations of the Mexican peso, which reduced Mexican tourism by an estimated one-third. Declining numbers of foreign visitors have been offset in part by increased in-state travel by California residents. Some modest pickup in business travel has occurred coinciding with recovery in the domestic economy.

The outlook for California tourism in 1984 is quite favorable. Improved domestic and international economic conditions and some decline in the dollar's value will favor greater travel for both business and pleasure. Improved consumer debt positions, moderate inflation, and rising employment should also stimulate travel. Perhaps most important for 1984 will be two special events—the Summer Olympics in Los Angeles and the Democratic National Convention in San Francisco. The Olympics are expected to attract up to 600,000 visitors, yielding a direct revenue impact of almost $1 billion. The Democratic Convention is expected to bring 25,000 to 30,000 people to San Francisco, generating direct expenditures of over $50 million.

The Olympics and the convention will have substantial impacts throughout the California economy. The primary short-term effects will be the revenues generated and their flow to the many businesses serving the tourism sector. In addition, state and local tax revenues will be boosted appreciably. Employment gains should be significant, since every $50,000 of travel expenditures supports on average one travel-related job. Longer term, both events will benefit the state through extensive media coverage leading to future tourism gains.

California's Population Growth Poses Some Problems

California has added about 1.9 million new residents since 1980, almost a half million more than any other state. Despite high housing costs, growth controls, and other limiting factors, the state's population is growing at a rate of about 2 percent a year—nearly twice the national rate, higher than had been previously forecast, and ahead of the 1.7 percent rate recorded during the 1970s.

The key to this rapid population growth has been the large net migration into California, which occurred despite a severe recession that temporarily pushed the state's unemployment rate above the national rate. California ranks a close third—behind Texas and Florida—in the net number of migrants since the start of 1980.

Population growth, however, has not been evenly distributed across the state. The mountain region, southern suburban area, and San Joaquin Valley are currently experiencing the highest growth rates. (See map). The northern urban region, by contrast, has the slowest rate of growth, amounting to only about half of the state's total growth rate. This disproportionately rapid population growth in nonmetropolitan areas is creating a variety of difficulties for local governments as well as the new residents in the high growth areas.

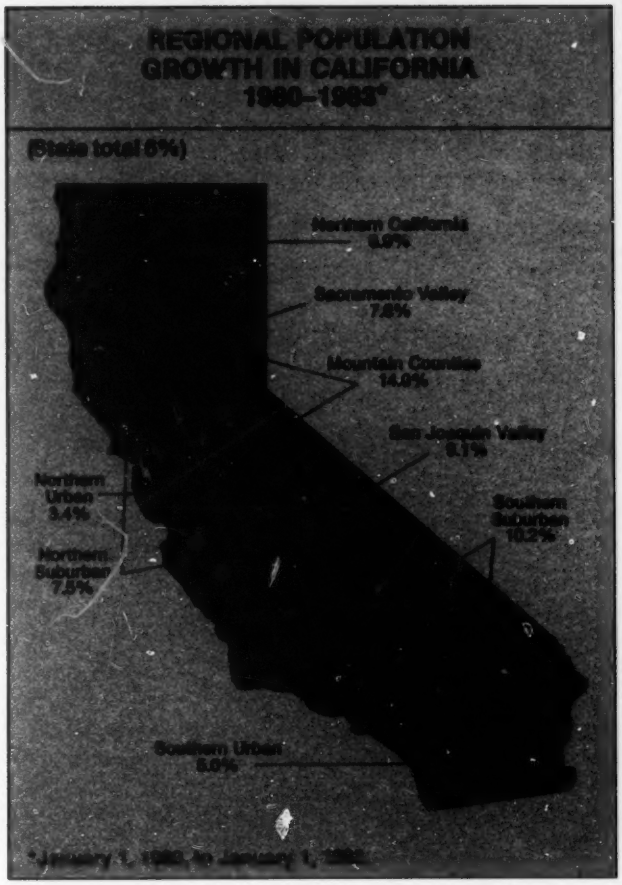
While there is some evidence that jobs are following people to the suburbs, by and large most new factories, offices and other commercial spaces are being built in coastal urban areas. Since 1980, for example, approximately 80 percent of all commercial construction has taken place in the coastal urban areas of the state. Similarly, about 70 percent of all industrial construction has taken place in these regions.

With the coastal urban areas experiencing increased job growth and—at the same time—slowing population growth, more Californians are forced to commute longer distances. This pattern is placing increased pressure on the state's transportation infrastructure at a time when expenditures for maintenance of streets and highways are not keeping pace.

Local governments and school districts in communities experiencing rapid population growth are facing increasing financial burdens at a time when their means of financing new infrastructure and educational programs is limited. Before the passage

of Proposition 13 in 1978, local government entities found it relatively easy to finance public facilities through the use of general obligation bonds. However, the implementation of Proposition 13 has placed severe constraints on the use of these bonds by local governments and school districts.

Local governments have turned increasingly to state government for financing assistance. The state is hard-pressed to provide funding when it is struggling to balance its own budget. Consequently, a number of local communities are left unable to fully provide necessary services for their growing populations. Finding means to provide such services is one of the most critical problems facing both state and local governments over the next several years.



Bank of America NT&SA, founded in 1904 by A. P. Giannini, has some 1,077 branches in California communities and 135 branches and representative offices overseas. As of September 30, 1983, BankAmerica Corporation's consolidated assets were more than $122 billion.

Prepared by the Economics-Policy Research Department of Bank of America using data available as of 11/5/83. Additional copies of this report may be obtained by writing to Corporate Communications Planning and Administration #3401, Bank of America, Box 37000, San Francisco, CA 94137.

Bank of America